DOCUMENT RESUME

ED 398 631 EA 027 794

TITLE Annual Audits of School Districts and Related State Education Department Oversight. Report No. 96-J-1.
INSTITUTION New York State Office of the Comptroller, Albany.
PUB DATE 12 Jul 96
NOTE 51p.
PUB TYPE Reports - Evaluative/Feasibility (142)

EDRS PRICE MF01/PC03 Plus Postage.
DESCRIPTORS *Compliance (Legal); *Educational Finance; *Efficiency; Elementary Secondary Education; Federal Regulation; *Financial Audits; Public Schools; *School Districts; School District Spending; *State Standards
IDENTIFIERS *New York

ABSTRACT

New York State's Education Law requires local school districts with eight or more teachers and all Boards of Cooperative Educational Services (BOCES) to obtain annual independent audits. They are required to submit annual audit reports to the State Education Department. The Department also requires these entities to obtain a "Single Audit" if they receive federal assistance over $25,000. This report presents findings of an audit that examined the procurement, use, and quality of annual school-district audits and the related oversight provided by the New York State Education Department. The audit concludes that the department and school districts need to work to ensure that they are receiving quality audits that comply with applicable requirements. In addition, department and district managers should use school-district audits more effectively. It is suggested that they use a competitive selection process in which the quality of the proposed services is equal or more important than the price; and consider peer-review results of the auditor's work, extent of the auditor's continuing professional education, and the auditor's governmental and single-audit experience. Ongoing reviews of the audit work being conducted are also needed. In summary, the department should consider changes to the annual audit and subsequent report to enable audited data to be used for state aid purposes. Appendices contain a list of major contributors, a list of school districts visited, and comments from department officials. (LMI)

****
* Reproductions supplied by EDRS are the best that can be made *
* from the original document. *
****

ED 398 631

EA

EA 027 794

BEST COPY AVAILABLE

State of New York
Office of the State Comptroller

Division of Management Audit
Division of Municipal Affairs
Office of the State Deputy Comptroller for the City of New York

Report 96-J-1

Mr. Carl T. Hayden
Chancellor, Board of Regents
The University of the State of New York
State Education Department
Albany, NY 12234

Dear Mr. Hayden:

The following is our report on the procurement, use and quality of annual school district audits and the related oversight provided by the State Education Department and school districts.

Our audit was performed pursuant to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution, Section 8, Article 2 of the State Finance Law, and Article 3 of the General Municipal Law. We list major contributors to the report in Appendix A.

Office of the State Comptroller
Division of Management Audit

July 12, 1996

In an effort to reduce the costs of printing, if you wish your name to be deleted from our mailing list or if your address has changed, contact Raymond W. Cocon at (518) 474-3271 or at the Office of the State Comptroller, Alfred E. Smith State Office Building, 13th Floor, Albany, NY 12236.

Executive Summary

Annual Audits of School Districts and Related State Education Department Oversight

Scope of Audit

The State's Education Law (Law) requires local school districts with eight or more teachers, and all Boards of Cooperative Educational Services (BOCES), to obtain annual independent audits. About 750 school districts and BOCES are required to submit annual audit reports to the State Education Department (Department). Also, the Department requires these entities to obtain a Single Audit if they receive Federal financial assistance in excess of $25,000. Audit engagements or contracts must satisfy government auditing standards and/or Federal Single Audit Act requirements. The Department also issues guidelines to assist auditors in doing these audits.

Our audit addressed the following questions about the Department's and school districts' oversight of school district audits:

- Can improvements be made to increase the likelihood that quality audits of school districts, which comply with applicable requirements, are being conducted?
- Can Department and school district managers use school district audits more effectively?

Audit Observations and Conclusions

The Department and school districts need to work to ensure they are receiving quality audits which comply with applicable requirements. In addition, Department and school district managers should use school district audits more effectively.

When obtaining auditing services, school districts should use a competitive process with the quality of the proposed services being equally or more important than the price. Factors such as peer review results of the auditor's work, extent of the auditor's continuing professional education, and the auditor's governmental and single audit experience should be considered in assessing quality of services. Most districts we reviewed, and more than 40 percent of the districts responding to our survey, did not use a competitive process for auditing services. In addition, quality issues were not always considered. The Department should advise school districts on implementing an appropriate procurement process for auditing services. (See pp. 7-10)

There is a strong need for ongoing reviews of the audit work done. We reviewed a judgmental sample of 22 audits involving 21 independent auditors, who together audited 249 school districts and BOCES. We found that six audits may be so seriously deficient as to call into question whether the auditors met applicable standards and requirements. The six auditors that did these deficient audits had conducted a total of 11 school district and BOCES audits. We are referring those audits to the Department's Office of Professional Discipline, which is the State disciplinary body for the accounting profession, for investigation and appropriate action. Substandard school district audits do not satisfy Federal requirements, or the need for public accountability and disclosure. (See pp. 10-12)

Single Audits need to satisfy Federal requirements for report quality and presentation, follow-up and problem resolution, and timeliness. A 1989 Federal audit of the Department found several problems in these areas, which continue to exist. (See pp. 13-16)

Some school district officials perceive the audits and resulting reports as being more encompassing than they are. Other types of audits would be necessary to address such expectations. (See pp. 17-19)

Department staff generally do not use audited financial statements to monitor school districts or make funding decisions. Instead, staff rely on unaudited financial and attendance data. For example, Department staff verify district claims for State aid to unaudited data. Our comparison of audited financial statements to such unaudited data showed that 15 of 18 school districts reported amounts that varied significantly from the audited financial statements. The Department should consider changes to the annual audit and resulting report to enable audited data to be used for State aid purposes. (See pp. 20-21)

The New York City Board of Education (Board) includes 32 community school districts. We found that Board required limited reviews of internal controls and compliance were useful, but could be improved by expanding the scope of work done and by issuing the reports more timely. We also found that financial statement audits were conducted in only 10 districts, and that the scope and timeliness of these audits can be improved. Such improvements could better satisfy Board needs and meet the statutory audit requirements. In addition, while the Single Audit of the Board was generally in compliance with requirements, our review showed that 12 major programs, totaling $115 million, were incorrectly excluded from compliance testing, and small sample sizes were used when testing was done. (See pp. 25-33)

Comments of Department Officials

Department officials generally agreed with our conclusions and recommendations and have taken action to implement the recommendations.

Contents

Introduction	Background	1
	Audit Scope, Objectives and Methodology	3
	Comments of Department Officials	5
Quality of School District Audits	Procurement of Auditing Services	7
	Monitoring the Quality of Auditing Services	10
	Ensuring Compliance with Audit Requirements	13
Use of Audits	Meeting Stated Audit Objectives	18
	Verifying State Aid to School Districts	20
	Correcting School District Deficiencies Identified in Audit Reports	22
New York City Board of Education School District Audits and Reviews	Directive 1 Reviews	26
	Financial Statement Audits	28
	Federal Single Audit	31
Appendix A	Major Contributors to This Report	
Appendix B	School Districts Visited During This Audit	
Appendix C	Comments of Department Officials	

Introduction

Background

Section 2116-a of the Education Law requires local school districts with eight or more teachers, and all Boards of Cooperative Educational Services (BOCES), to obtain an annual audit of their records by an independent certified public accountant (CPA) or an independent public accountant (PA). The law requires all annual audit reports to be in a format prescribed by the State Education Department (Department), and be certified by the auditor. School districts and BOCES, whose fiscal years end on June 30, must submit audit reports to the Department by October 1 annually. General fund expenditures of school districts statewide exceed $22.6 billion annually. Available Department data shows that 668 school districts annually spend more than $6.9 million for auditing services. Available records show that outside of New York City, annual auditing costs range from $400 to $75,247.

The Education Law also requires both the New York City Board of Education and its 32 community school districts to obtain annual audits by a PA, CPA or the City Comptroller. Community school district audits may also be done by the Board of Education's Office of Auditor General. The 1993-94 audit and related services for the New York City Board of Education, including community school districts, cost about $1.1 million.

In addition to the State's annual audit requirement, the Federal Single Audit Act requires school districts and BOCES, receiving $100,000 or more in Federal aid, to obtain an annual audit that complies with the U.S. Office of Management and Budget Circular A-128 (Circular). School districts receiving between $25,000 and $100,000 in Federal aid may obtain an audit either in accordance with the Circular or with Federal laws and regulations governing their applicable programs. (Subsequent to our audit, the new Federal legislation was enacted amending the Federal Single Audit Act which raises the minimum requirement for Single Audit to $300,000.) To monitor subrecipient use of Federal funds, the Department's Reference Manual for Audits of Financial Records of School Districts (Reference Manual) requires school districts receiving more than $25,000 of Federal funds to obtain a Single Audit.

Although the two audit requirements (Federal Single Audit and annual State audit) result in separate reports, in essence, much of the work necessary to satisfy the State's annual audit requirement also is required

by the Single Audit Act. Therefore, our audit findings relate to the overall quality of audit work done.

School district boards act independently in selecting and engaging auditing services. Audit engagements undertaken by the auditors must satisfy generally accepted government auditing standards (Government Auditing Standards issued by the Comptroller General of the United States), and Federal Single Audit requirements, if applicable. The Department also provides guidance about required audits through its Reference Manual, and staff is available for consultation. The Reference Manual lists the major objectives of the annual audit as follows:

- determine whether financial statements are fairly presented,
- ascertain that an adequate accounting system and appropriate internal controls exist,
- disclose where the school district has not significantly adhered to its authorized budget,
- determine whether the school district has properly accounted for funds, and
- determine whether funds provided for specific purposes were expended and used only for authorized purposes.

Federal funds for local school districts flow through the Department. Consequently, the Department is the designated recipient, and the school districts and BOCES are Department subrecipients. The Circular requires recipients that pass Federal funding on to subrecipients in excess of $25,000 annually to:

- determine whether the subrecipients have met the Circular's audit requirements,
- determine whether Federal funds were spent according to applicable laws and regulations,
- ensure that appropriate corrective action of noncompliance is taken within six months after receiving the audit report, and
- consider whether the audits require adjustment of Department records.

The Department's Office of Finance Management and Information Services (Office) is responsible for reviewing all audits, except for the Single Audits of Buffalo and New York City. The Federal Department of Education reviews these Single Audits. At the time of our review, the Office had one full-time employee assigned to review these audits.

Our audit addressed the issues of audit quality and use on a statewide basis. While upstate and New York City school districts share some common practices and problems related to obtaining required annual audits, many issues are unique to New York City, because of its organizational structure, existing oversight mechanisms and entities, and the types of audits contracted for. Therefore, for reporting purposes and to facilitate the readers' understanding of the issues involved, we addressed those issues for the New York City Board of Education and its 32 community school districts in a separate section of this report.

Audit Scope, Objectives and Methodology

Our audit, covering the period July 1, 1991 through July 28, 1995, examined the Department's oversight and monitoring of annual school district audits as well as Single Audits, the school districts' procurement of these audits, the use of these audits by interested parties, and the quality of these audits. We also audited the use and quality of annual audits of New York City community school districts. The primary objectives of our performance audit were to determine whether (1) the Department and school districts have procedures in place to provide reasonable assurance that they are receiving quality audits which comply with applicable requirements, (2) Department and school district managers could use school district audits more effectively, and (3) to determine the adequacy of identification and resolution of audit deficiencies, compliance with audit reporting requirements and the timeliness of audit report submission.

We conducted this audit through the joint efforts of the New York State Comptroller's Division of Management Audit, Division of Municipal Affairs, and the Office of the State Deputy Comptroller for New York City. To accomplish our objectives, we reviewed relevant laws and regulations as well as the Department's procedures for overseeing, reviewing and following up on school district audit reports.

We also visited 19 school districts (including the New York City Board of Education), two BOCES, 10 New York City community school districts, as well as the independent auditors for these entities to determine how the audits were obtained and to analyze the quality of the audit work done. (See Appendix B for a list of the school districts visited.) In reviewing the quality of annual and Single Audits, we used the President's Council on Integrity and Efficiency's (PCIE) Uniform

Quality Control Review Guide for A-128 Single Audits. We also sent questionnaires to 100 randomly selected school board presidents, to obtain and evaluate information concerning the procurement, use, and benefits of school district audits. We received 66 responses from school board presidents.

We conducted our audit according to generally accepted government auditing standards. Such standards require that we plan and do our audit to adequately assess those Department and school district procedures and operations included within our audit scope. Further, these standards require that we understand the Department's and school districts' internal control structure and design the audit to provide reasonable assurance about compliance with those laws, rules and regulations that are relevant to the Department's and school districts' procedures and operations which we include in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those procedures and operations that we have identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, we devote little audit effort to reviewing procedures and operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Comments of Department Officials

Draft copies of the matters contained in this report were provided to Department officials and to officials of the school districts we audited for review and comment. Accordingly, we have directed our recommendations to the Department, to school districts in general and to the New York City Board of Education. Their comments were considered in preparing this report and the Department's response is included in Appendix C. Department officials generally agree with our conclusions and recommendations and have taken action to implement the recommendations.

Within 90 days after the final release of this report, as required by Section 170 of the Executive Law, the Commissioner of the State Education Department shall report to the Governor, the State Comptroller, and leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

Quality of School District Audits

We noted that both the school districts and Department need to work to ensure that quality audits are obtained through a competitive process. School districts should strongly consider quality issues, such as peer review results, continuing professional education, as well as governmental and Single Audit experience, when evaluating offers for auditing services. The Department can help school districts in these efforts by providing guidelines for establishing a competitive process for obtaining quality audit services.

In addition, there is a strong need for ongoing reviews of the work of independent auditors. While the primary means of ensuring audit quality lies with the individual school districts and the adequacy of their procurement practices, the Department is at risk of not complying with Federal requirements for Single Audits if the audits obtained do not satisfy applicable standards. Moreover, seriously deficient annual audits do not satisfy the need for public accountability and disclosure by school boards to taxpayers and State policymakers. We have also addressed the issues relating to the audit quality of New York City audits in a subsequent section of this report.

Procurement of Auditing Services

The General Municipal Law requires, among other things, that public work contracts exceeding $20,000 be awarded to the lowest responsible bidder. However, this law does not apply to the acquisition of professional services, such as auditing, because such services involve specialized expertise, use of professional judgment and a high degree of creativity. To ensure the prudent and economical use of public moneys in the taxpayers' best interests, General Municipal Law further requires the governing board to adopt policies and procedures for all procurement when competitive bidding is not required. In awarding contracts, the quality of the proposed services is equally or more important than the price. However, the Department does not provide guidance to school districts on how to balance the need for quality with the need for controlling cost.

We found that most of the 22 school districts we reviewed did not use a competitive process to obtain auditing services. Some districts had never used competition, while others had done so at some point, but then continued with the same firm for several years. Even when a competitive process was used, school districts did not always consider quality issues when evaluating proposals. However, we did find that the contract to audit the New York City Board of Education and its 32

community school districts was awarded through a competitive bidding process.

In addition, of 86 school districts responding to our random survey, over 40 percent stated they did not use a competitive process when selecting their auditors. Officials from some school districts stated they did not obtain competition for auditing services because the law did not expressly require it. Officials from the remaining 60 percent of the school districts surveyed responded that they used some form of requests for proposals, quotes or competitive bidding. However, in some cases, the selection process appeared to center only around cost considerations. In addition, some school districts did not execute a contract or engagement letter with the auditor to specify the type and scope of the audit to be provided. We believe school districts should execute a written contract or an engagement letter with the independent auditor. Written engagement agreements are important because they document the contractual responsibilities of the school district and the auditor and they help to reduce misunderstandings.

Generally accepted government auditing standards recognize the need for auditors to meet quality standards by meeting certain requirements in the areas of continuing education, quality control and external peer review. In addition, the Department's Reference Manual advises local school boards to verify that such requirements are met when evaluating proposals. However, the Reference Manual does not mention the importance of the auditor's prior experience with Single Audits. The results of our audit show that such prior experience is strongly correlated with audit quality.

A 1987 U. S. General Accounting Office study, "CPA Audit Quality - A Framework for Procuring Audit Services," identified four critical attributes necessary for an effective audit procurement system. These include open competition, a formal process for requesting audit services, technical evaluation of experience and ability, and a written audit agreement. The study determined that an entity using all four attributes could expect to receive a quality audit 77 percent of the time. Whenever cost was the sole consideration in selecting an auditor, the rate of acceptable audits was a mere 10 percent.

A recent article, "Common Attributes of Quality Audits" published in the Journal of Accountancy highlighted the relationship between audit procurement practices and audit quality. Audit firms that received unqualified peer reviews and had government auditing experience were more likely to do quality audits.

Our audit work also noted a strong correlation between audit experience, peer reviews and resulting audit quality. As detailed in a subsequent section of this report, we reviewed the work papers of 22 school district audits and are concerned that six may not have met auditing standards. The six problem audits were conducted by firms that each audit fewer than five school districts annually, and three were conducted by firms that had not successfully completed a peer review within the last three years. In addition, three auditors had not met continuing professional education requirements. We also found that for two of the six audits, there was no contract or engagement letter.

Implementing a competitive process which includes the evaluation of auditor qualifications, and price, will help ensure that school districts obtain quality audits. One way school districts can incorporate quality measures into a competitive process is to assign weights to various quality aspects, and price, in arriving at a final decision. Each category would be evaluated and its numerical rating would be multiplied by the assigned weight. We also believe that prospective auditors need to be informed of such a process to allow them the opportunity to properly present their proposals.

In addition, school districts should execute a written contract or an engagement letter with the independent auditor. The engagement letter should identify the nature and scope of the engagement, the type of report the auditor is expected to issue, timing of rendering the services, and a target date for issuing the auditor's report.

Moreover, the Reference Manual does not provide guidance about what school districts should include in a contract for an audit, nor does it require school districts to enter into written contracts with their auditors. The Department should develop guidance for items to include in an audit contract and make them part of the Reference Manual.

Recommendations

To the Department:

1. Provide necessary guidance and oversight to school districts to aid them in obtaining quality audit services at a reasonable cost through a periodic competitive process.

2. Revise the Reference Manual to guide school districts on the format and content of audit engagement letters or contracts.

(Department officials agreed with these recommendations.)

To School Districts:

1. School districts should periodically (every three to five years) issue requests for proposals for auditing services. In determining quality, procurement guidelines should address an evaluation or rating of issues such as evidence of external peer reviews, continuing professional education, school district and single audit experience, and other relevant factors.

2. Execute formal audit engagement letters or contracts when obtaining audit services.

Monitoring the Quality of Auditing Services

We selected and reviewed a judgmental sample of 22 school district and BOCES audits involving 21 independent auditors, who together audited a total of 249 school districts and BOCES. Our judgmental sample of audits included CPAs who audited fewer than three districts and CPAs who audited 20 or more districts. We also considered auditing costs, geographic location and district financial condition in selecting districts for review. Our purpose was to assess whether the work done was according to professional auditing standards, Department objectives, and Federal Single Audit requirements.

Our review identified that six audits, involving six independent auditors, may be so seriously deficient as to call into question whether the auditors met applicable standards and requirements. These six auditors had conducted a total of 10 school district audits and one BOCES audit. We provided officials from the Department, school districts and auditing firms with appropriate details regarding these audits. We are also referring these matters to the Department's Office of Professional

Discipline, which is the State disciplinary body for the accounting profession, for investigation and appropriate action.

As noted previously, the auditing firms which did this work had deficiencies relating to experience with school districts, peer reviews, and professional education requirements. The following is a summary of the audit areas where the six questionable audits did not meet applicable standards or requirements:

- Five audits had deficiencies relating to evaluation of the districts' internal control structure in one or more of the following areas: failure to perform audit procedures to understand controls, failure to determine whether school district procedures were implemented, failure to document the auditor's understanding of controls, and failure to document the assessed level of control risk.

- The work papers for five audits did not demonstrate an understanding, and failed to document and test internal controls over major Federal programs.

- Three audits had deficiencies in compliance testing for major Federal programs (both general and specific).

- In all cases, audit work papers did not adequately document the audit scope and did not stand on their own according to quality assurance guidelines.

The other 16 audits we reviewed had some deficiencies in varying degrees in one or more areas. However, on an overall basis, we concluded that these audits met standards. We noted deficiencies in the areas of due professional care, quality control, planning and supervision, work paper standards, and other matters.

The Federal Department of Education audited the Department's operations in 1989. This audit recommended, and we agree, that the Department should annually complete some quality control reviews of school district audits. Division managers did not implement this recommendation because of staff constraints. However, the Department should consider ways this could be done with existing staff.

Based on our quality control reviews of the 22 audits we reviewed, we estimate that about ten to fifteen days are needed to complete five such reviews annually. The Department has an audit staff that conducts ongoing audits of individual school districts. The Department should

investigate whether this audit staff could include a quality control review of the independent auditors' work papers during some of their school audits. We believe such quality control reviews would serve as a means to help enhance the quality of audit work.

The Department could also explore the possibility of requiring that audit firms doing school district audits include such audits in external peer reviews which are already required. This could satisfy the quality control review requirement without the use of additional Department resources.

Recommendations

To the Department:

3. Establish an ongoing system to conduct a sample of quality control reviews of audits. Considering existing staff limitations, investigate the feasibility of using existing Department audit staff, on a limited basis. Another possibility is requesting the independent peer reviewers to include at least one school district audit in their external peer reviews of school district auditors.

4. Require school districts to obtain and submit evidence of the auditors' experience with school district audits, peer review results, and compliance with continuing professional education requirements.

5. Work with professional organizations to improve training for independent auditors in doing school district audits.

(Department officials agreed with these recommendations.)

To School Districts:

3. Obtain evidence of the auditors' experience with school district audits, peer review results, and compliance with continuing professional education requirements. Submit evidence that these items were verified to the Department, along with the audit reports to help the Department in identifying possible areas of concern with audit quality.

Ensuring Compliance with Audit Requirements

To meet audit requirements and to be useful to all interested parties, it is important that school district Single Audits satisfy Federal requirements relating to report quality and presentation, follow-up and problem resolution, and timeliness. The 1989 Federal audit of the Department found several problems in these areas. We found that many of these problems continue to exist. Some audit reports do not satisfy requirements and are not corrected. We also found that the Department's desk review process needs improvement. Finally, not all school districts have submitted required audits or have not submitted them timely.

Correction of Audit Report Deficiencies

The 1989 Federal audit found that Office management has accepted audit reports from auditors which had significant deficiencies. These deficiencies included required sections missing from Reports on Internal Controls, Compliance, and the Schedule of Federal Financial Assistance. We found that Department management needs to ensure that deficient reports are corrected by the auditors.

We judgmentally selected for review 60 annual audit reports submitted for the last three fiscal years for 18 school districts and two BOCES. We found that, in 17 of the 60 audits, Department staff notified school districts of Single Audit report deficiencies. However, the Department did not require that corrected audit reports be submitted.

Department management stated they do not require auditors to submit corrected audit reports. However, Department staff needs to determine whether such deficiencies have been subsequently corrected. While district officials are requested to indicate how they will address problems with the audit reports, we noted that districts do not always respond. Department staff often cited districts for the same report exceptions in consecutive years. In some cases, district responses to repetitive problems are unchanged from year to year.

We found that the Department continued to cite six of these school districts and one BOCES for the same audit report deficiencies in subsequent years. Deficiencies included substandard Reports on Compliance, Reports on Internal Controls and Schedules of Federal Assistance.

Our review also shows that audit reports generally do not contain information that would place noncompliance issues in proper perspective, as required by government auditing standards. Essential elements should include the extent of the condition, number of instances, number of cases examined and the audit universe. If this information was available to

Department staff, they would have a basis to rank their follow up to address the more important issues.

These continuing deficiencies indicate that school districts and/or their auditors are not complying with Federal audit requirements. In addition, when school district audit reports are deficient, Department and district officials may not be receiving necessary information for managing and overseeing school district operations.

Recommendation

To School Districts:

4. Require that deficient audit reports be promptly corrected and resubmitted. Jointly consider, with Department officials, a process which could result in not re-engaging an auditor when audit reports are not corrected and submitted as required.

Desk Reviews of Audit Reports

Desk reviews of audit reports are important for evaluating compliance with applicable reporting requirements. Department managers need to employ a more comprehensive review process to help ensure the identification of audit reports that do not comply with applicable standards. Department staff currently uses two desk review checklists, one for the Single Audit report and another for annual financial statements. These checklists are not as comprehensive as the one we used, which the President's Council on Integrity and Efficiency (PCIE) recommends.

We used the PCIE checklist to review a judgmental sample of six audit reports that were previously desk reviewed. Based on the PCIE checklist, we identified exceptions with two reports that had not been detected previously because desk reviewers were not looking for them. In one case, the auditor's Report on Internal Control failed to identify those categories into which he classified the significant internal control structure policies and procedures. In another case, the auditor's Report on Compliance did not place findings in perspective by relating the extent of noncompliance to the number of cases examined, the dollar amounts tested and the universe. The Report on Compliance also failed to include pertinent views of district officials, planned corrective action and other related information. This would be necessary for officials to

determine the cause and effect of the finding so that they could take timely and proper corrective action.

U.S. Department of Education officials, in their 1999 audit, recommended that desk review staff meet certain auditing qualifications relating to knowledge, skills and continuing education. Instead of these qualifications, they stated that a strong system of supervisory oversight and review may be acceptable. We noted that neither of these conditions exist. Neither the supervisory staff nor the desk reviewer meets the above auditing qualifications. One supervisor told us that some desk reviews are checked for accuracy. However, we found no evidence of supervisory review for the reports we analyzed. In addition, there are no formal procedures requiring supervisors to check desk reviews.

Recommendations

To the Department:

6. Revise the desk review process to include the PCIE checklist to help identify deficient audit reports.

   (Department officials agreed with this recommendation.)

7. Comply with Federal recommendations relating to the qualifications of desk review staff and/or a system of supervisory review of desk audits.

8. Issue the PCIE checklist to the school districts' independent auditors so they can review their audit work and reports for compliance.

   (Department officials agreed, in part, with these recommendations. Officials stated that the best qualified staff will be assigned to supervise and perform desk audits within existing staffing limits. In addition, the PCIE checklist will be publicized in the 1997 Reference Manual revisions.)

Timeliness of Audit Report Submission

The usefulness of an audit report to interested parties depends, in part, on its timeliness. Department staff tracks the receipt and review of audit reports. We reviewed available records to determine whether school districts have submitted reports timely.

For the 1992-93 school year, three school districts received from $25,000 to $155,000 in Federal financial assistance but did not submit the required Single Audit report. There are no procedures to capture available data and identify those entities required to submit reports. After our review, Office officials notified these school districts to submit the audit.

We also determined whether all districts had submitted their annual audits by October 1 as required by State law. Six school districts and one BOCES had not submitted audit reports more than seven months past the deadline.

The Department had procedures to send late notices to delinquent school districts and BOCES. However this process was not effective, since these school districts received several letters and a phone call but still did not comply.

Recommendation

To the Department:

1. Identify those school districts required to submit audits. Investigate why school districts do not submit audit reports on time. Consider possible sanctions for noncompliance with report submission requirements.

(Department officials agreed with this recommendation.)

Use of Audits

School district audits can be very beneficial when they meet the stated audit objectives, required auditing formats, standards and time frames, as well as user perceptions and expectations. Audit reports can provide useful information regarding a school district's financial condition, the adequacy of its accounting systems and internal controls, and its compliance with applicable laws, rules and regulations. In addition, reports can disclose whether school districts have adhered to authorized budgets and proper fund accounting, and whether funds provided for specific purposes were expended and used only for authorized purposes.

The U.S. General Accounting Office's (GAO) publication, Government Auditing Standards, classifies audits as either financial audits or performance audits. The type of audit done is determined by the audit objectives.

Financial audits include financial statement and financial related audits. Financial statement audits provide reasonable assurance about whether the financial statements of the auditee present fairly the financial position, results of operations and cash flows in conformity with generally accepted accounting principles. Financial related audits include determining whether (1) financial information is properly presented, (2) the entity has followed specific financial compliance requirements or (3) the entity's internal control structure over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve the control objectives.

Performance audits include economy and efficiency and program audits. Economy and efficiency audits include determining (1) whether the entity is acquiring, protecting and using its resources economically and efficiently, (2) the causes of inefficiencies or uneconomical practices and (3) whether the entity has complied with laws and regulations on matters of economy and efficiency. Program audits include determining (1) the extent to which the desired results or benefits established by the Legislature are being achieved, (2) the effectiveness of organizations, programs, activities or functions and (3) whether the entity has complied with significant program laws and regulations.

Audit reports can be used for many purposes by school boards, taxpayers, public interest groups, banks, bond rating companies and the Department. School boards are required to exercise proper stewardship of assets and should use audit reports to determine whether district financial operations are acceptable, as well to correct any deficiencies in

financial controls or operations. Department and school district managers should use this data to help assess the financial condition and practices of school districts, and to determine whether school districts have appropriately obtained and used Federal and State funds.

We found that some school district officials perceive that the audits and resulting reports they receive are more encompassing than they are. In addition, Department and school district managers need to make better use of audit services and reports to monitor and improve operations. We also found that reported recommendations to improve school district operations are not always implemented. In addition, we have addressed the issues related to the use of New York City school district audits in a subsequent section of this report.

Meeting Stated Audit Objectives

As part of the questionnaire we sent to officials of 100 school districts, we asked whether officials receive any benefits from the annual audit, and whether the annual audit could be improved. Our intent was to determine whether officials were knowledgeable about the audits' objectives, whether their expectations and perceptions are in line with the objectives of these audits, and whether improvements can be made to better use audit services.

While, for the most part, officials were aware of the audits' basic objectives, we found that some officials believed that the audits provided more than they could, given their limited scope, cost and duration. For example, some officials stated that the audits serve to:

- validate employee honesty,
- maximize State aid,
- ensure efficiency, integrity and/or credibility,
- measure staff effectiveness, and
- ensure that funds are spent properly and wisely.

These responses show that officials ascribe certain qualities to these financial audits which the auditors do not purport to provide. Other types of audits would be necessary to address the above objectives, such as performance audits, special fraud reviews, or program audits.

Based on our review, we concluded that the scope of the current annual financial audits and Single Audits adequately fulfills the Department's major audit objectives. However, we do not believe that these audits can, nor are they intended to, on a more comprehensive basis, determine whether the school district officials used the funds appropriately and reasonably. These objectives more closely relate to some of the above

expectations voiced to us by school district officials responding to our survey. These objectives can only be met through some form of performance auditing or in-depth reviews of expenditures.

School district officials also gave us comments relating to improving the annual audit process. Suggested improvements included:

- economy and efficiency audits or reviews,
- in-depth audits of expenditures, State aid claims and program funds,
- service efforts and accomplishment audits, and
- providing more operating data to taxpayers and other interested parties.

The Department and school districts need to ensure that funds allocated for annual audits are efficiently and effectively utilized to provide the most appropriate audit services. Therefore, the Department, in conjunction with school district officials, needs to review its objectives and determine whether different types of periodic audits would be helpful to all parties.

Recommendations

To the Department:

10. Review, in conjunction with school district officials, the established objectives for annual audits. Determine whether the objectives need to be revised to meet the expectations of school district officials.

    (Department officials agreed, in part, with this recommendation, and stated that revisions will be considered in discussions with the public accounting committee, in time for the 1997 Reference Manual revision.)

11. Train school officials to help them further understand the scope and objectives of annual audits, as well as those audit services that may be necessary to enhance the usefulness of audits to all parties.

    (Department officials agreed with this recommendation.)

Verifying State Aid to School Districts

Accurate financial and operating data is essential to Department managers for overseeing and monitoring school districts. In addition to audited financial statements, the Department requires districts to submit unaudited data, such as the Annual Financial Report (ST-3) and attendance data. The ST-3 provides detailed budgetary, revenue and expenditure data for such categories as the districts' General Fund, Special Aid, Food Services, Trust Fund, Debt Service, and Capital Fund. Department officials use the ST-3 to verify the school districts' State aid claims. Amounts reported in the audited financial statements should agree on an overall level with the ST-3. Where variances are identified, the school district should reconcile the differences and submit an amended ST-3.

We found that Department staff generally do not use the audited financial statements to monitor school districts or make decisions involving their funding. Instead, staff relies almost entirely on the unaudited ST-3s and unaudited attendance data. For example, Department staff check school district claims for State aid to unaudited ST-3s. The Department's State aid unit does not regularly use data from the audited financial statements as a check on claim validity. Department officials are reluctant to require additional detail in the audited statements because it could result in higher audit fees for school districts.

We compared audited financial statements to ST-3s for 18 districts. We found that individual amounts reported on the ST-3s for 15 school districts varied, by thousands to hundreds of thousands of dollars, from amounts reported in the audited financial statements. In addition, our audits of school district operations, involving ST-3s, have shown significant differences between reported and actual figures. These individual discrepancies may be considered material in relation to a school district's overall finances. Department officials told us that discrepancies in certain categories, such as transportation, could result in higher or lower State aid payments to that district.

Department staff relies on the unaudited ST-3s rather than the audited financial statements for several reasons. First, the ST-3 provides financial data in much greater detail than the audited statements. Therefore, using audited school district statements for any statewide analysis or comparison of school district finances would be difficult because of the absence of significant detail. Second, ST-3 data is automated, enabling Department officials to obtain it electronically. In contrast, audited financial statements are paper documents filed by school districts.

We believe Department managers need to make better use of audited financial data. Where possible, the Department should seek to have audit reports include more data from the ST-3s and include a statement that the ST-3 agrees in summary form. In addition, efforts should be made to ensure the reliability of attendance data, which is a basis for determining a significant portion of funding. Department staff could then use such data to help obtain greater assurance that State aid claims are as reasonable and accurate as possible. Audited data could also increase the accuracy of data used by Department managers in their oversight and monitoring of school districts.

Recommendations

To the Department:

12. Require school districts to resubmit corrected ST-3s when discrepancies are identified through the audit process. Explore the possibility that independent school district auditors could identify and report on the differences between the ST-3 and their certified financial statements.

    (Department officials agreed with this recommendation.)

13. Consider changes to the annual audit and resulting report that would provide some assurance that financial expenditure and non-financial attendance data used for State aid purposes can be relied upon.

    (Department officials disagree with this recommendation and stated that changes made to implement recommendation 12 will provide assurance regarding expenditure data. They also stated that requiring additional auditing work by independent auditors of non-financial attendance data would result in substantial additional costs to school districts. They did state that the Department's audit group will conduct tests of non-financial attendance data as part of their audits of school districts.)

Auditors' Comment - The annual financial reports do not provide the detailed expenditure data used in making State aid calculations, and the Department's audit group audits only a few school districts each year. We recognize that the additional cost to school districts needs to be considered in making any determinations on the extent of audit coverage that is required. The cost to audit all State aid data each year may be excessive, however, some data might be included at a minimal extra cost or could be done less frequently. Before making a final determination, the Department needs to estimate and analyze the additional costs and benefits to determine if some additional work could be done to improve the State aid payment process.

To School Districts:

5. Resubmit corrected ST-3s when discrepancies are identified through the audit process.

Correcting School District Deficiencies Identified in Audit Reports

Another important potential benefit of school district audit reports is the timely identification and correction of school district fiscal deficiencies. Our review of audit reports, management letters and results of Department audit reviews for 20 districts showed that many deficiencies noted in school district audits remain uncorrected for several years or longer. We found that auditors for 16 of 20 districts reported the same findings in multiple years during 1991-92 through 1993-94. Typical findings that have gone uncorrected include:

- inadequate accounting for fixed assets,
- undesignated fund balances exceeding the legal limit of 2 percent of appropriations,
- expenditures made without a school board appropriation,
- problems related to separation of duties and account reconciliation,
- noncompliance with audit report presentation requirements,
- inappropriate accounting for grants, and
- noncompliance with regulations governing extra classroom activity funds.

While school district officials are primarily responsible for correcting such problems, Department staff should follow up on reported deficiencies to ensure that corrective action is underway. However, they generally rely on the subsequent year's management letter to report whether problems have been corrected. As a result, many deficiencies remain uncorrected. We believe that funds spent on the annual audit would be used more effectively if school districts and Department managers use information from the audits to correct deficiencies.

The Federal Single Audit Circular requires the Department to ensure that school districts correct noncompliance within six months after the audit. The 1989 Federal audit found that some audit findings were unresolved from 11 to 20 months after the audit. We selected a judgmental sample of 11 audits (10 school districts and one BOCES) to determine if Department staff followed up with school district officials to ensure that corrective action was taken as required. In seven cases, Department staff had not determined if school districts had taken corrective action.

The timeliness of Department follow-up is also important. We identified 13 audit reports for 1993-94 which were referred for follow-up more than six months after receipt. Department staff stated they review audit reports alphabetically by school district name, rather than in order of receipt. This is done so that staff can readily locate the reports. However, this process does not enable staff to ensure that school districts are taking timely corrective action.

Recommendation

To the Department:

14. In conjunction with school district officials, implement a system which ensures that operating deficiencies are followed-up and corrected in a timely manner. Require school districts to submit a plan to correct fiscal deficiencies identified through the audit report process. General Municipal Law provides that such a plan should be submitted within ninety days of the presentation of the audit report to the school board.

(Department officials agreed with this recommendation.)

New York City Board of Education School District Audits and Reviews

For reasons noted previously, we devote the following section of this report exclusively to issues relating to the quality and use of New York City school district audits and reviews.

The City of New York, on behalf of the New York City Board of Education (Board), contracted with two CPA firms to conduct the annual audits of the City's 32 community school districts for fiscal years 1994-1997 (10 financial statement audits and 22 Directive I reviews for fiscal year 1994). The Board prescribes how these audits will be conducted. The contract also required the CPAs to do the annual audit of the Board, as a whole. At 22 districts, the CPA firms did limited reviews of internal controls and tested compliance with Board operating procedures based on agreed upon procedures (Directive I reviews) with the assistance of the Board's Office of Auditor General (OAG). At the other 10 districts, the CPA firms did an audit to certify the district's budgeted and actual data. The CPAs also did the Federal Single Audit of the Board.

Our main audit objectives were to evaluate the quality of the school district audits done, and to determine whether the audit results were useful to school district management. We also evaluated the CPAs' working papers for 10 of the 22 Directive I reviews to determine whether they were done according to OAG standards, and we also assessed the adequacy of the scope of the planned work. We evaluated the scope of the financial statement audits and the timeliness of their completion. Furthermore, we surveyed district officials to determine their opinions regarding the quality and usefulness of these audits. Our audit covered Districts 3, 4 and 6 in Manhattan, District 8 in the Bronx, Districts 15, 20, and 21 in Brooklyn, Districts 24 and 25 in Queens, and District 31 in Staten Island. We also reviewed the Single Audit to determine whether it met Single Audit requirements.

We found that the Directive I reviews were performed by the CPAs in accordance with OAG agreed upon procedures. However, Directive I reviews could be improved by expanding the scope of work done and by issuing the reports more timely. These changes could result in audits that would satisfy the needs of the Board and community school districts, as well as meeting the statutory requirement for an annual audit of each city school district. In addition, some working papers supporting the CPAs' work could not be found. Management at each of the ten districts visited believed that these reviews were beneficial to their operations but indicated areas of possible improvement, such as faster report issuance and the use of more representative sample sizes.

Our review of the CPA firms' performance of the Board's Single Audit found that the CPAs incorrectly excluded 12 major programs for which the Board received $115 million, from compliance testing. We also questioned whether the small sample sizes used by the CPAs for compliance testing were sufficient.

Directive I Reviews

We found that the Directive I reviews were useful, but could be improved by expanding the scope of audit work done and by issuing the reports on a timely basis.

The OAG, as part of the Directive I reviews, does detailed reviews of each district's annual financial statements. If the scope of the work done for reviews was expanded, we believe that under current State law, the OAG may be able to certify these School district financial statements for all 32 districts.

Timeframes for Issuance of Directive I Reports

The CPAs forward draft reports of the review to the district. The CPAs then incorporate the district's response to the draft report into the final report that they transmit to the OAG for issuance. The OAG then includes district financial data (budgeted and actual expenditures) before issuing the final report to the Board and School district. The contract between the City and the CPA firms requires that the final report be issued by February 15 of the year following the fiscal year audited.

As of February 1996, the OAG issued 20 of the 22 Directive I final reports for fiscal year 1994. The 20 reports were issued an average of ten months after the due date. OAG stated that the lack of timely issuance of the final reports was due to delays in receiving certain required district financial data and delays in receiving the responses from

the districts. The lack of timely issuance reduces the usefulness of these final reports.

The delay in OAG issuing the final reports was a major concern to the districts as by the time they are received, the district is being audited for the next year. District officials indicated that the receipt of the final report was important as this is the document that is distributed to other parties, such as the community school board. The OAG and CPA firms maintained that the findings were provided to district officials on a timely basis, but acknowledged that this was not documented in the working papers. The CPAs indicated that such documentation was maintained for fiscal year 1995. While the districts may have received most of the findings in a timely manner, we believe that the timely receipt of the final report is important for interested Board officials and external monitors.

Scope of OAG's Agreed Upon Procedures

To evaluate each district's compliance with internal control directives, the CPAs test controls in several areas. The audit procedures to accomplish this objective are set forth in the Directive 1 review program.

The CPA firms use the audit programs developed by the OAG to determine compliance with various Board operating directives. For each district, the CPA does audit steps at the district office and eight schools within the district. We reviewed the CPA's working papers for our ten sampled districts to evaluate whether the CPA complied with the Directive 1 review program.

However, the audit program does not require the CPAs to document their sampling methodology. For example, although the program requires that a sample of ten inventory items be selected, it does not require the CPA to document the size of the sampling population, nor the method used to select the sample, e.g., random, judgmental. Consequently, we were unable to evaluate if the sample size used was sufficient and properly selected or if the sample was representative of the population.

The CPAs were in general compliance with the OAG program requirements for the Directive 1 reviews. Nevertheless, our review disclosed several shortcomings regarding the scope of the OAG audit program. For example, the procedures that the CPA was required to follow to verify the propriety of employees charged to reimbursable programs was different from that for special education, and not sufficient to determine the veracity of these charges. In addition, the audit program requires

that the CPA find out if the community school district uses consultants. We found that this determination was made solely through an inquiry with community school district officials, instead of through independent determination based on a review of district expenditures by budget codes.

Directive 1 reviews could be designed to draw conclusions about sampled populations. This would provide more meaningful results regarding the integrity of school district internal controls. Based on our review, we concluded that some sample sizes required in the audit program were not large enough to draw valid conclusions about the populations from which they were selected. In addition, the required sampling plan would not necessarily detect fraud or abuse. Board officials responded that Directive 1 reviews were designed to report actual errors, and not to draw conclusions about the population or to detect fraud or abuse.

The CPA was unable to find the working papers for District 3 and for a segment of the work performed for District 25. Therefore, we could not fully evaluate compliance with the review program for two of these ten districts.

In-Depth Approach to Directive 1 Reviews

Based on our review of the Directive 1 review programs, the scope and focus of Directive 1 reviews, which cost the Board $18,000 per district, can be improved by doing more in-depth reviews of selected areas such as payroll, purchasing, or inventory controls, on a rotating basis, instead of doing limited reviews in all of the areas. The OAG should determine the design of these reviews with input from the districts and the CPA firms. This type of review would be consistent with the type of work normally done by internal auditors and may be a better use of the limited available resources. An OAG official agreed that some areas in the Directive 1 review program could be done on a rotating basis, but that others, such as the purchasing and inventory areas, should be covered each year.

Financial Statement Audits

The Education Law requires both the Board and its school districts to obtain annual audits in a form prescribed by the Commissioner and certified by the accountant or the Board's Bureau of Audit. The financial statement audits done by the CPAs were intended to provide reasonable assurance on the reliability of the district's annual financial statements of budgeted and actual expenditures. The CPA firm expresses an opinion on these statements regarding the fairness of presentation and conformity with generally accepted accounting principles. These audits also involved a review of the internal controls over the budgeting process

to ensure that budgets are properly allocated to the appropriate locations and that budget modifications are properly authorized and recorded. The scope of internal control testing performed as part of these audits is significantly less than that performed for a Directive I review, and correspondingly, the financial statement audits cost the Board an average of $10,000 per district, $8,000 less than Directive I reviews.

Work papers supporting these certified audits were unavailable for our review because the CPA firms would not make them available before the reports were finalized. However, we found that the audit program, which the CPA firm prepared, places significant reliance on the information obtained from interviewing district officials. The audit program calls for limited testing to determine if the amounts shown by the district for tax levy, special education, the Federally-funded Chapter I program and other reimbursable programs are reasonable. In addition, no testing is required to determine if these amounts include charges that belong to other budgets. No other evidence of the planned audit work was provided.

The Board's program of performing certified audits at school districts has been less than successful. For fiscal year 1994 only 10 of the 32 school districts were scheduled to receive financial statement audits. However, only one of the ten final certified audit reports for fiscal year 1994 had been issued as of March 1996, almost two years after the close of the audited fiscal year. OAG explained that the lack of timely issuance of the final reports was due to delays in receiving required district financial data. This type of audit was not conducted by the CPAs for fiscal year 1995.

Some of the important issues at the school district level are the propriety of transactions and the overall adequacy of internal controls. We believe that the financial statement audits performed by CPAs did not fully address these issues. Moreover, the scope of the Directive I reviews can be modified to address these issues and to comply with the annual audit requirement.

Recommendations

To the Department and the New York City Board of Education:

1. Work together to assess the extent of audit coverage necessary to meet the needs of the Board and the community school districts, and to comply with the law. Based on this assessment, take the lead in either expanding the scope of the financial statement audits or, if necessary, changing the Education Law to provide for more meaningful audit coverage.

   (Board officials agree and Department officials concur that school districts should receive greater audit coverage and stated that they have already initiated discussions with SED, the Board's external CPA firms and the Joint Committee on Public School Accounting of the NYS Society of CPAs in order to specify the scope and objectives of adequate audit coverage in compliance with State law.)

2. Ensure that the final audit reports are issued in a timely manner.

   (Board officials agree and Department officials concur with this recommendation.)

3. Document and reevaluate the sampling methodology to ascertain if the sample sizes are sufficient to draw valid conclusions of the population being audited.

   (Board officials stated that although the Directive 1 agreed upon procedures require testing, they do not specify the sampling methodology to be applied nor do they require that the CPAs draw conclusions from these tests. However, Board officials also stated that in line with their initiatives to determine adequate audit coverage mentioned in Recommendation 1, they will re-define the scope and methodology of what are currently the Directive 1 agreed upon procedures, consistent with that new audit coverage.)

Recommendations (continued)

4. Ensure that CPA firms' working papers are available for review.

   (Board officials stated that the CPA firms' policy regarding review of their working papers is that they are available for review anytime after the final audit report is issued.)

Auditors' Comment - Our concern was that there were considerable delays in the issuance of the final reports which precluded our review of the working papers. Also, extensive delays could render the reports useless to external monitors.

Federal Single Audit

For fiscal year 1994, there was a City-wide Single Audit and report, as well as a separate Single Audit and report for the Board of Education. This was required by the contract between the City and the CPA firms. The contract provided for a separate fee for the Board's Single Audit, and stipulated that the CPA firms assign a separate audit team and engagement partners. We found that the CPAs, in carrying out the Federal Single Audit of the Board, incorrectly excluded 12 major Federal Board programs totaling $115 million from compliance testing. We also questioned the sufficiency of the sample sizes used for the required tests of compliance with program requirements, and the fact that certain districts were excluded from the sample selection process.

When a Single Audit is done of a department, the auditor is required to report on the compliance for each "major" Federally funded program. The Board received a total of $905 million in Federal funding for fiscal year 1994. Based on this level of assistance, the Circular's threshold was $3 million for determining which Board programs are "major." During this period the Board had 19 programs that exceeded this threshold. Our review showed, however, that the CPAs incorrectly used $20 million as the threshold for determining which of the Board's programs were "major." The $20 million threshold would apply to the city-wide Single Audit, but not the department audit. We should note that in the prior year's Single Audit, the previous CPA, in determining which programs were major programs for audit purposes, correctly applied the $3 million threshold in determining which programs required compliance testing. Instead of doing compliance testing for these 12 major programs, the current CPAs used a questionnaire approach, which is designed to obtain documentation of the procedures the Board uses to

administer the non-major programs. This does not substitute for the required testing specified for the Single Audit.

We have been advised by Board and Federal officials that the issues of separate Single Audit reports and appropriate thresholds are under review. If the Board is included in the City-wide Single Audit, then the higher $20 million threshold for major programs would apply. Board officials indicated to us that a separate Single Audit report will not be produced for fiscal year 1996.

Our review of the sample methodology used by the CPAs to do the compliance testing found several problems. First, we noted that the sampled transactions were selected from only the 10 districts in which certified audits were being conducted, thereby excluding tests at the other 22 districts. We believe this level of testing is not adequate to provide sufficient competent evidential matter to enable the auditor to render an opinion regarding compliance with the various requirements.

In addition, the CPAs' objective in reviewing the Chapter I program, the Board's largest remedial program, with expenditures of $426 million in fiscal year 1994, includes determining eligibility of program costs and the eligibility of students enrolled in the program. To meet the eligibility objective the CPAs only selected a sample of five students from the 290,447 student population. Similarly, in the tests of the Bilingual program, the CPAs relied on a sample of only five students to draw conclusions. Our review found that similar sample sizes were used to test compliance with other requirements for other programs.

Recommendations

To the Department and the New York City Board of Education:

5. Require the CPA firms to comply with Federal Single Audit requirements for compliance testing for all major programs.

   (Board officials stated that the threshold for compliance testing of major programs is still in dispute and they are seeking clarification from the cognizant Federal agency. They further stated that they will require the CPA firms to comply once this issue has been clarified and resolved.)

6. Require the CPA firms to perform sufficient testing of major programs where sampling is done.

   (Board officials agree and will implement this recommendation pending resolution of the threshold for major programs in accordance with the Federal Single Audit Act.)

Major Contributors to This Report

David R. Hancox
Carmen Maldonado
Stanley Marszalek
Allen Vann
Wallace Donnelly
Stanley Evans
Albert Kee
Robert Lindholm
Cole Hickland
Fredrick Perlmutter
Michael Solomon
Joseph Dickson
Jack Dougherty
Jerry Jadlowski
Charles Johnson
Beverly Karpf
Charles Kuonen
Chester Roberts
Gregory Smith
Dianne Hart
Thomas Kulzer
Joanne Kavich
Arthur Lebowitz
Divya Mathur
Paul Sheldon
Michael Tonowitz
Paul Bachman

School Districts Visited During This Audit

* SCHOOL DISTRICT	COUNTY	FISCAL YEAR ENDED 6/30/94 REPORTED EXPENDITURES IN MILLIONS
Amsterdam City	Montgomery	$ 31.2
Arlington Central	Dutchess	$ 61.2
Ballston Spa Central	Saratoga	$ 37.2
Central Islip Union Free	Suffolk	$ 65.1
Cooperstown Central	Otsego	$ 9.3
Dunkirk City	Chautauqua	$ 24.1
East Ramapo Central	Rockland	$ 120.5
Elmira City	Chemung	$ 70.5
Fabius-Pompey Central	Onondaga	$ 8.1
Freeport Union Free	Nassau	$ 68.6
Greece Central	Monroe	$ 114.9
Hoosick Falls Central	Rensselaer	$ 9.2
Hudson Falls Central	Washington	$ 18.6
Narrowsburg Central	Sullivan	$ 2.9
Sachem Central	Suffolk	$ 151.8
Saranac Central	Clinton	$ 16.9
Syracuse City	Onondaga	$ 220.8
Williamsville Central	Erie	$ 92.5
Albany Schoharie Schenectady BOCES		$ 45.3
Orange Ulster BOCES		$ 33.5
New York City		$9,397.1

* *One additional annual audit was reviewed, however, the school district was not visited during this audit.*

THE STATE EDUCATION DEPARTMENT

April 11, 1996

Mr. David R. Hancox
Director of State Audits
Office of the State Comptroller
A.E. Smith Office Building
Albany, NY 12236

Dear Mr. Hancox:

Thank you for your letter of March 15, 1996 transmitting the Office of the State Comptroller's Draft Audit Report (96-S-1) on Annual Audits of School Districts and Related State Education Department Oversight. The following is our response to the findings and recommendations.

RECOMMENDATIONS

1. Provide necessary guidance and oversight to school districts to aid them in procuring quality audit services at a reasonable cost through a periodic competitive process.

   We agree with the recommendation. The 1996 Reference Manual for Audits of Financial Records has been revised accordingly. This topic will also be covered in the five annual statewide workshops.

2. Revise the Reference Manual to guide school districts on the format and content of audit engagement letters or contracts.

   We agree with the recommendation. The 1997 Reference Manual will include reference to a sample engagement letter.

3. Establish an ongoing system to conduct a sample of quality control reviews of audits. Considering existing staff limitations, investigate the feasibility of using existing Department audit staff, on a limited basis. Another possibility is requesting the

independent peer reviewers to include at least one school district audit in their external peer reviews of school district auditors.

We agree with the recommendation. We will investigate the feasibility of using Department audit staff, on a limited basis, to assess the quality of audits. We will also encourage school districts to obtain copies of peer review reports prior to contracting for audit services. We will also investigate the possibility of having peer reviews include at least one school district audit in their external peer reviews.

6. Require school districts to obtain and submit evidence of the auditors' experience with school district audits, peer review results, and compliance with continuing professional education requirements.

We agree with this recommendation. This will be included in the sample engagement letter mentioned above.

7. Work with professional organizations to improve training for independent auditors in performing school district audits.

We agree with the recommendation. This is done with the New York State Association of School Business Officials and the Public Accounting Committee through statewide workshops.

8. Revise the desk review process to include the PCIE checklist to help identify deficient audit reports.

We agree with the recommendation. The desk review checklist which is based on the PCIE checklist is evaluated on an annual basis for comprehensiveness and responsiveness to current legislation and requirements.

9. Comply with Federal recommendations relating to the qualifications of desk review staff and/or a system of supervisory review of desk audits.

We agree, in part, with the recommendation. Within the limits of staffing, the best qualified staff will be assigned to supervise the program and review the audits. Additional training will be provided as necessary.

10. Issue the PCIE checklist to the school districts' independent auditors so they can review their audit work and reports for compliance.

We agree, in part, with the recommendation. The PCIE checklist will be publicized in the 1997 revision of the Reference Manual.

9. Identify those school districts required to submit audits. Investigate why school districts do not submit audit reports on time. Consider possible sanctions for non-compliance with report submission requirements.

We agree with the recommendation. Districts not submitting audits on time will be included in the dunning process currently established for the annual financial report and state aid claim documents.

10. Review, in conjunction with school district officials, the established objectives for annual audits. Determine whether the objectives need to be revised to meet the expectations of school district officials.

We agree, in part, with this recommendation. This will be considered in discussions with the public accounting committee, in time for the 1997 revision of the Reference Manual.

11. Train school officials to help them further understand the scope and objectives of annual audits, as well as those audit services that may be necessary to enhance the usefulness of audits to all parties.

We agree with this recommendation. This will be included in the curriculum offered in the annual statewide workshops.

12. Require school districts to re-submit corrected ST-3s when discrepancies are identified through the audit process. Explore the possibility that independent school district auditors could identify and report on the differences between the ST-3 and their certified financial statements.

We agree with the recommendation. Districts are already advised on the cover letter to the ST-3 to submit changes resulting from the auditing process. A process of comparing selected independent audit totals and subtotals with comparable data requested on the ST-3 to identify areas of large discrepancies will be implemented with the 1995-96 review process. If large discrepancies are identified, a computer generated notice and request for ST-3 corrections will be sent to the district. Independent auditors will also be asked to advise the district to submit corrected financial data as a revision to the ST-3.

BEST COPY AVAILABLE

13. Consider changes to the annual audit and resulting report that would provide some assurance that financial expenditure and non-financial attendance data used for State aid purposes can be relied upon.

We disagree with the recommendation. The revised process of identifying discrepancies between the ST-3 and the independent audit report described in response to Recommendation #12 will accomplish the recommended assurance regarding financial expenditure data used for state aid purposes. To require additional auditing work by the independent auditors of non-financial attendance data would result in substantial additional costs to school districts, and the current audit report has not documented that such costs could be justified in terms of increased accuracy of attendance reports or savings in state aid. The Department's Office of Audit Services will conduct tests of non-financial attendance data as part of their audits of school districts.

14. In conjunction with school district officials, implement a system which ensures that operating deficiencies are followed-up and corrected in a timely manner. Require school districts to submit a plan to correct fiscal deficiencies identified through the audit report process. General Municipal Law provides that such a plan should be submitted within ninety days of the presentation of the audit report to the school board.

We agree with the recommendation. A requirement for follow-up of operating deficiencies will be included in the sample engagement letter in the 1997 Reference Manual.

Sincerely,

Thomas E. Sheldon

THE STATE EDUCATION DEPARTMENT / THE UNIVERSITY OF THE STATE OF NEW YORK / ALBANY, N.Y. 12234

EXECUTIVE DEPUTY COMMISSIONER OF EDUCATION
THE NEW YORK STATE EDUCATION DEPARTMENT
ALBANY NEW YORK 12234

June 14, 1996

Mr. David R. Hancox
Director of State Audits
Office of the State Comptroller
A.E. Smith Office Building
Albany, NY 12236

Dear Mr. Hancox:

On April 11, 1996 you received the Department's formal comments to draft audit report 96-J-1 on Annual Audits of School Districts and Related State Education Department Overight. You asked that responses to findings and recommendations to the New York City Board of Education be held pending your revisions. Based on those subsequent revisions you have given the Department another opportunity to respond to findings and recommendations.

The Department concurs with the New York City Board of Education's response. Since the recommendations are only changed as to New York City recommendations, the New York City Board of Education's Response to Audit Report 96-J-1 is enclosed. Because your Recommendations to the Department were not revised, our April 11, 1996 formal comments are unchanged.

We appreciate the attention the staff of the Office of the State Comptroller has given to analyzing school district audits.

Please call me if you need any additional information.

Sincerely,

Thomas E. Sheldon

Enclosure

THE BOARD OF EDUCATION OF THE CITY OF NEW YORK

Response to Audit Report 96-J-1 of the Comptroller of the State of New York:
ANNUAL AUDITS OF SCHOOL DISTRICTS AND RELATED STATE EDUCATION DEPARTMENT OVERSIGHT

Recommendations to the New York State Education Department (SED) and the New York City Board of Education:

1. "Work together to assess the extent of audit coverage necessary to meet the needs of the Board and the school districts, and to comply with the law. Based upon this assessment, take the lead in either expanding the scope of the financial statement audits or, if necessary, changing the education law to provide more meaningful audit coverage."

   Board of Education's Response:

   We agrees that school districts should receive greater audit coverage. And we feel equally as strong about the need for more coverage for the rest of the Board. We have already initiated discussions with SED, the Board's external CPA firms and the Joint Committee on Public School Accounting (of the NYS Society of CPAs). We will be scheduling meetings with these groups, and with school district officials, to specify the scope and objectives of adequate audit coverage in compliance with state law. We invite the State Comptroller's Office to join us.

2. "Ensure that the final audit reports are issued in a timely manner."

   Board of Education's Response:

   The State's conclusion relative to the timeliness of issuance of the final report is valid. This is, and continues to be, a top priority of ours, which is why OAG inserted the self-imposed deadline of February 15th into the current contract.

3. "Document and reevaluate the sampling methodology to ascertain if the sample sizes are sufficient to draw valid conclusions of the population being audited."

   Board of Education's Response:

   Although the Directive 1 agreed upon procedures require testing, they neither specify the sampling methodology to be applied nor require that the CPAs draw conclusions from these tests. The objectives and intent of the agreed upon procedures were to report actual errors and areas of noncompliance among the

items tested, not to "*draw conclusions about the populations from which items were selected*", or to detect fraud or abuse. However, in the event that fraud or abuse was detected, it was reported to OAG and the Special Commissioner of Investigation.

Therefore, it is unnecessary both to assess whether the number of items tested is representative of the number of items in the total population, and to require that the CPAs document their sampling methodology.

As we proceed with discussions and problem solving initiatives mentioned in our response to recommendation 1, we will re-define the scope and methodology of what are currently the Directive 1 agreed upon procedures consistent with that new audit coverage.

6 "Ensure that the CPA firms' working papers are available for review."

Board of Education's Response:

The CPA firms' policy regarding review of their working papers is that they are available for review any time after the final audit report is issued.

9 "Require the CPA firms to comply with Federal Single Audit [Act] requirements for compliance testing for all major programs."

Board of Education's Response:

The state comptroller's report is based upon two assumptions. The first is that the USDOE is the cognizant agency for the Board. And the second is that the City has selected a department-by-department approach to the single audit. This second assumption is based upon the fact that CPA contract with the City required a separate audit and report, specified a separate fee and stipulated a separate audit team and engagement partner for the Board of Education. Had the City selected a department-by-department approach to the single audit, which it did not, then the auditors would be required to report on the compliance for each "major" federally funded program for the Board of Education at a threshold of $3 million.

The Board is pursuing clarification of these issues with the United States Department of Health and Human Services, which, according to our understanding - and theirs - is the cognizant agency for New York City, and, therefore, the Board of Education. (See attached letter seeking confirmation.)

Therefore, we believe that the final audit report should be amended to inform the reader that the issues of cognizant agency for the Board of Education for the purposes of the single audit, the determination of threshold, and the issuance of a separate report are all in dispute, pending resolution.

We will require the CPA firms to comply with the Act when the issues, as stated above, have been clarified and resolved.

6. "Require the CPA firms to perform sufficient testing of major programs where sampling is done."

Board of Education's Response:

We agree and will implement this recommendation, pending resolution of the disputed issues, above.

BOARD OF EDUCATION OF THE CITY OF NEW YORK

May 15, 1996

John H. Fisher, Ph.D., CPA
U.S Department of Health & Human Services
Office of Inspector General
Office of Audit Services
Lucas Place, Room 314
323 West 8th Street
Kansas City, Missouri 64105

Re: The Federal Single Audit

Dear Dr. Fisher:

I am writing to you on behalf of the Board of Education (Board) of the City of New York (City). As the manager of the External Liaisons Audit Implementation Unit of the Board's Office of Auditor General, I am responsible for all external audit activity, including the federal single audit.

As I mentioned to you during our telephone conversation, there are differing opinions among the New York State Comptroller's Office, the City's external CPA firm, KPMG Peat Marwick, and the Board, regarding the cognizant agency and the testing threshold for the federal single audit of the Board. Additionally, in a phone conversation with Bernard Talley from USDOE, he confirmed that USDOE is not the Board's cognizant agency, but the Board's oversight agency.

The Single Audit Act provides that the scope of a single audit "shall cover the entire operations of a state or local government." It is KPMG's and the Board's understanding that, since the Board is a dependent school district and a component unit of the City, the City of New York is the single audit reporting entity. Therefore, the major program threshold should be determined on a city-wide basis, calculated on total federal financial assistance expenditures for the entire city.

I have stated the Board's understanding of the single audit requirements below:

- The US Department of Health and Human Services is the cognizant agency for New York City, and, therefore, for the Board of Education.
- The single audit threshold level should be calculated on a city-wide basis. (This establishes the reporting threshold as $20 million.)

- The single audit of New York City, including the Board as a component unit, satisfies the single audit requirement for the Board.

- The Board is not required to conduct a separate single audit or perform additional testing (i.e. at a threshold other than the City's threshold) in order to comply with federal guidelines, even though in previous years, in addition to being included in the City's audit, the Board produced a separate single audit report. The report was sent to the United States Department of Education (USDOE), which the Board believed to be its cognizant agency.

- The proposed changes in the Single Audit Act will remove funding to pay for the additional single audit report.

- The prior practice of producing a separate report for the Board should not influence the major program threshold determination for the Board.

Based on the above, and beginning with FY 1996, there will be one single audit report for the City of New York, which will include the Board as a component unit. The prior practice of producing a separate report for the Board will be discontinued.

Please inform me in writing, and as soon as possible, of your agency's position and authority in this matter, confirming - wherever possible - our position and understanding of the circumstances as stated above.

Should you require additional information, please call me at (718) 935-2591/2599.

Thank you for your assistance in clarifying these issues.

Sincerely,

Edward Torres

Edward Torres

EJT:db

c: Bernard Tadley, USDOE
James R. Comey, NYC Board of Education
Michael King, NYC Board of Education

KPMG Peat Marwick LLP

345 Park Avenue
New York, NY 10154

Telephone 212 758 9700
Telex 420038

Telefax 212 758 9819

May 24, 1996

Mr. John M. Fischer
U.S. Department of Health and Human Services
Office of Inspector General
Office of Audit Services
Lucas Place Room 314
323 West 8th Street
Kansas City, Missouri 64105

Dear Mr. Fischer:

The purpose of this letter is to provide a summary of the approach and reporting practice applied to the single audit of the Board of Education of The City of New York (the Board) as a part of the City-wide single audit. We would also like to obtain confirmation from your office as to the appropriateness of the approach and reporting procedures outlined below for the City of New York's entity-wide single audit.

The Board is an agency of The City of New York (The City) and is therefore considered a part of the City for single audit report purposes. Furthermore, The City has historically followed a city-wide (entity-wide) approach, as opposed to a department-by-department approach. It is also our understanding that The City, including the Board, has only one cognizant agency, that being the U.S. Department of Health and Human Services.

Past practice has been that a separate single audit report has been issued for the Board, by KPMG and other firms previously engaged by The City, even though a department-by-department single audit approach was not utilized. For internal reasons, the Board has historically requested its auditors issue this separate report. The Board's total federal expenditures have also historically been reported in the schedule of federal financial assistance included in the City-wide single audit report. For the fiscal year ended June 30, 1994, a separate report was issued for the Board as had been the past practice. However, within that report and in the City-wide single audit report, disclosures were provided to clarify the fact that the single audit had been performed on a City-wide basis.

A recent audit performed by the New York State Comptroller's Office, which included a review of the single audit workpapers related to the federal programs administered by the Board, raised and questioned the Board's practice of producing a separate report. The City's election of an entity-wide vs. department-by-department approach, and the identification of the cognizant agency

To clarify and demonstrate for all users of The City's single audit report, a separate Board single audit report will not be prepared beginning with the fiscal year ending June 30, 1995. One entity-wide single audit report will be issued, and will include all federal expenditures administered by the Board, as they have been in the past, and all findings related to the programs administered by the Board will be included.

We hope that this summary and the issuance of only one entity-wide single audit report will clarify any misunderstanding as to the entity-wide approach that has been applied in performing the single audit for The City.

We would greatly appreciate your response in writing to the change in reporting procedures which we have described above and confirmation of the facts as laid out above. We would like to thank you for your time and consideration in this matter.

Very truly yours,

KPMG Peat Marwick LLP

John R. Miller
National Partner-in-Charge of Government Assurance Services

Watson Rice & Co. P.C.

Raymond P. Jones
Partner

KPMG Peat Marwick LLP

Nancy A. Valley
Engagement Partner

bcc: E.H. Brown
J.R. Coney
L.L. Stark